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## POLICY RESEARCH WORKING PAPER

1763

# China and the Multilateral Investment Guarantee Agency

*Yushu Feng*

In developing countries with little foreign direct investment (FDI), the Multilateral Investment Guarantee Agency (MIGA) can serve as a catalyst for more such investment. In China, which now attracts one-third of all FDI in developing countries, MIGA should perhaps help screen that investment and set up demonstration projects to improve the quality and sustainability of FDI.



## Summary findings

The Multilateral Investment Guarantee Agency (MIGA), established in 1988, is part of the World Bank Group. Its mandate is to promote foreign investment in its member countries by providing political risk insurance and technical assistance to promote investment.

In developing this case study of China's evolving relationship with MIGA, Feng asked: Why did China decide to seek membership in MIGA? What was the outcome of the relationship between China and MIGA? How has that relationship affected economic and legal reform in China and the country's integration with the multilateral investment insurance system? How can MIGA strengthen its role? And how can MIGA prevent potential claims to its portfolio in China?

MIGA's comparative advantages are its international experience in underwriting and operating its portfolio, its neutral position and approach, its mediation and legal advice, and the fact that its guarantee portfolio is unaffected by bilateral relations.

Feng suggests that in China, MIGA should screen foreign direct investment (FDI), not just encourage it,

because some FDI in China has been of poor quality, with little transfer of skills and technology. Some local partners have conceded too many discounts to foreign investors, without considering the cost of key assets such as land and machinery. Some foreign investors have taken advantage of local officials' eagerness for foreign capital, pressuring them to grant guarantees they should not grant and to allow unacceptable levels of environmental pollution in industry.

China receives one-third of all FDI in developing countries. To continue attracting such investment, it must design a rule-based legal system governing FDI, making its rules and regulations more transparent, uniform, and consistent with international practice. As a neutral third party, MIGA could make policy recommendations that authorities might consider and accept — such as policies designed to encourage less investment in labor-intensive firms and more in high-tech industries.

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This paper — a product of the Office of the Vice President and General Counsel, Legal Affairs and Claims, MIGA — is part of a larger effort in the Bank Group to promote foreign investment in its member countries. The paper was produced while the author was a visiting research fellow at the Bank. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Elisabeth Beers, room U12-121, telephone 202-473-6175, fax 202-522-2640, Internet address [ebeers@worldbank.org](mailto:ebeers@worldbank.org). May 1997. (37 pages)

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# China and the Multilateral Investment Guarantee Agency

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## **I INTRODUCTION**

The Multilateral Investment Guarantee Agency (MIGA), established in 1988, is part of the World Bank Group. Its mandate is to promote and encourage foreign investment into its developing member countries by providing political risk insurance and by providing technical assistance for investment promotion.<sup>1</sup> As of January 1997 MIGA has 141 members, of which 121 are developing countries.<sup>2</sup> Since its inception, MIGA has issued more than 225 guarantee contracts, which represent more than \$2.3 billion of contingent liabilities in about 40 developing countries.<sup>3</sup>

China returned to the international economic community by resuming its membership at the World Bank Group and the International Monetary Fund (IMF) in 1980.<sup>4</sup> In 1988, China joined MIGA. China's participation in MIGA is owed to two factors. First, China's successful inclusion in the World Bank and IMF provided China with valuable experience in participating in and cooperating with international economic organizations.

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<sup>1</sup> The objective of MIGA "shall be to encourage the flow of investments for productive purposes among member countries, and in particular to developing member countries". Article 2, MIGA Convention, 1985.

<sup>2</sup> Member countries are divided into two category: Category I ( industrial nations) and Category II (developing nations).

<sup>3</sup> MIGA Annual Report, 1996, and statistics from Guarantee Department of MIGA.

<sup>4</sup> This background is described and analyzed in Harold K. Jacobson and Michel Oksenberg: *"China's Participation in the IMF, the World Bank, and GATT"*, the University of Michigan Press, 1990.

Second, greater assurances for investors were deemed necessary to attract foreign direct investment (FDI) as China's economic reform progresses.

The next section of the paper analyses China's evolving relationship with MIGA by emphasizing the process and significance of China's integration into the international investment insurance regime represented by MIGA, and seeks to identify MIGA's role in China's integration. Section 3 examines MIGA's portfolio in China, focusing on the legal issues regarding the guarantee coverage, with a discussion of prevention of potential claims. Section 4 discusses MIGA's challenges and presents recommendations in light of a member country's perspective. Section 5 provides some concluding remarks.

## **II CHINA'S INTEGRATION**

### **1. China's recognition of the multilateral investment insurance system**

China's preparation to join MIGA triggered a domestic discussion involving academics and government agencies, including the Ministry of Finance (MOF), the People's Bank of China (PBC), the Bank of China (BOC), the People's Insurance Company of China (PICC), the State Administration of Foreign Exchange Control (SAFE), the China Council for Promotion of International Trade (CCPIT), and the China International Trade and Investment Company (CITIC). Different approaches towards MIGA's Convention were discussed.

First, with regard to disputes submitted to international arbitration, one approach considered that once MIGA is subrogated to a claim, its rights could never be greater than the rights of the original investors. The question is, if there is a dispute between China and MIGA as subrogee to an investor, the dispute might be submitted to an international arbitration agency which might not have been available to the investor to the same extent. In that case, it would be hard for China to accept, because the current practice of China related to the scope of acceptance of arbitration proceedings is limited only to the compensated amount, which was also stipulated in many bilateral investment treaties China has signed with other countries.

The advocates of this approach think that once MIGA functions as subrogee, the nature of dispute would change from a dispute between an investor and a host country to one between an international organization (MIGA) and a host country (China). As two entities under international law, such disputes might be submitted to international arbitration, according to existing international practice.

Second, with regard to applicable laws, one approach was that, to settle disputes between an investor (or its subrogee) and a host country, domestic laws of that host country should have priority. However, MIGA's Convention gave primacy to international law, and put a host country's domestic law into a second priority. This was not in conformity with the

principle that the settlement of investment disputes should be first resolved through a host country's domestic law.

The advocates of this approach held that once MIGA is subrogated to a claim, the nature of the dispute would change as discussed above; therefore, the applied laws relating to the settlement of disputes between two international legal entities should be determined by the agreement of both entities, in accordance with the MIGA Convention and related rules of international law.

Analyzing the foregoing approaches, the first one could be classified as "open and practical", which is based on the nation's open door policy. This approach sought every practical means to attract FDI in order to accelerate economic development. The second could be classified as "conservative and traditional", which put more emphasis on "sovereignty", and worried about possible loss of some aspects of sovereignty as the management of disputes occurred between investors and the government.

According to international law, the regulation of foreign investments is determined by the host countries.<sup>5</sup> But by joining MIGA, the sovereignty of a host country could be limited to some extent. To decide whether to join MIGA, the following legal issues were addressed in light of China's recognition. First, recognition that the MIGA

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<sup>5</sup> "Charter of Economic Rights and Duties of States" (UNGA Resolution 3281 of 1974) acknowledged each State's right to regulate foreign investment.



Convention prevails over domestic law. The relations between international and domestic law are stipulated in China's Civil Code.<sup>6</sup> That is to say, when there is a conflict between an international treaty (MIGA Convention) and domestic Chinese law or regulation, the treaty (MIGA Convention) has priority, unless China made reservations to some clauses of MIGA Convention while joining MIGA. Since the MIGA Convention has no clause allowing reservations, and is a constituent instrument of an international organization,<sup>7</sup> once China joined, China would probably have to accept all the provisions of the MIGA Convention. In addition, the guarantee contract between MIGA and an investor would bind indirectly to some extent the host country (China). With the system of priority of international law, is it prudent for China to decide to join or not?

Second, recognition of subrogation at multilateral level. At the domestic level, China recognizes subrogation.<sup>8</sup> At the bilateral level, China signed the Investment Incentive Agreement with United States in 1980, relating to investment insurance and investment guaranties which are administered by the Overseas Private Investment Corporation (OPIC). China agreed that OPIC could have subrogation for the investments in

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<sup>6</sup> "If there is a conflict between civil laws of People's Republic of China (PRC) and international treaties contracted or joined by the PRC, international treaties will apply with exception of reservations made by the PRC while contracting or joining." Article 142, China Civil Code, 1986.

<sup>7</sup> According to the "Vienna Convention on the Law of Treaties", if there is no clause allowing reservations in a treaty, it does not mean a State could not make a reservation. However, it is hard for a State to make a reservation to the MIGA Convention, because such a reservation may be incompatible with the object and purpose of MIGA Convention, and because such a reservation would in any event require the approval of the Council of Governors of MIGA. c.f. Article 19, and 20 of Vienna Convention on the Law of Treaties, Basic Documents in International Law, Clarendon Press, 1983.

<sup>8</sup> For example, China's Economic Contract Law stipulates that: "where a third party is liable to compensate for the loss of the insured property, should the insured demand it of the insurer, the latter may advance the compensation according to the contract provisions. But the insured must assign the right to claim to the insurer and assist the latter in claiming compensation from the third party." See: Article 25, Economic Contract Law, 1993.

China insured by OPIC.<sup>9</sup> These legal practices laid a solid foundation for China's recognition of subrogation at the multilateral level. This marks a progress toward further integration in an international investment insurance regime.

Third, recognition of international arbitration and its procedure. By joining MIGA, disputes between MIGA (as subrogee) and China will be settled through international arbitration instead of the host country's courts, and the arbitration tribunal may not apply only to the domestic regulations of the host country, but also the MIGA Convention and related international regulations.

## **2. Reasons for China's decision to join**

First, MIGA may not issue a political risk insurance contract without a host country's prior approval. This will provide the Chinese government with a prior opportunity to evaluate the nature of the investment and its non-commercial risk coverage and to decide whether to approve it or not, according to the nation's economic development priority.

Second, MIGA is an international economic organization, in which China is not only one of the key members, but also may have the opportunity to elect a member of the Board of Directors. International organizations should safeguard their member countries' interests. Under its Convention, MIGA is supposed to keep neutral in terms of politics; it

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<sup>9</sup> This agreement effected by exchange of notes, signed at Beijing on October 30, 1980.

must be an “honest broker” between the host country and foreign investors in terms of business.

Third, laws and regulations of a host country are respected. MIGA may not issue any insurance contracts that are inconsistent with the related laws and regulations of host countries. For example, regarding the risk of expropriation and similar measures, non-discriminatory measures of general application that governments normally take for the purpose of regulating economic activity are not covered by MIGA;<sup>10</sup> MIGA will not cover losses resulting from host government action or omission to which the holder of the guarantee has agreed or for which he has been responsible before the conclusion of the contract of guarantee.<sup>11</sup>

Fourth, the rights and obligations of both MIGA and China regarding MIGA’s portfolio in China were clarified in the agreement between the two which covered: i) the use of local currency, ii) legal protection, and iii) guidelines on project approval of MIGA guarantee. This agreement entered into effect between China and MIGA after China joined MIGA.

However, we should admit that MIGA, as an international organization, cannot serve the interests of one member or category of members at the expense of other members.

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<sup>10</sup> Article 11 (a) ii, MIGA Convention.

<sup>11</sup> Article 11 (c) ii, MIGA Convention.

Recalling the history of the creation of MIGA, it is obvious that the Convention was the result of a compromise on investment guarantee issues between developed countries and developing countries. Therefore, the Convention could not favor only one side. Thus, from the perspective of developing countries, some provisions in the Convention may be deemed to be unfavorable. Take, for instance, the issue of local remedies. The Convention only stipulates that investors will “seek ..... remedies” instead of requiring them to “exhaust.....remedies”.<sup>12</sup> The explanation given for this provision is that the provision should not impose an undue burden on investors since they should not be required to exhaust all local remedies before obtaining compensation from the Agency.<sup>13</sup> Of course, under general insurance practice it is not necessary for an insured to exhaust all local remedies.

### **3. Significance of China’s participation in MIGA**

First, participation in MIGA indicates that China’s open door policy to attract FDI is a national policy that is internationally recognized. Chinese authorities realized that it is important for the country’s economic growth to obtain technology and foreign exchange through actively encouraging FDI into the country. MIGA’s mandate is to promote FDI by

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<sup>12</sup> “Contracts of guarantee shall require holders of guarantees to seek, before a payment is made by the Agency, such administrative remedies as may be appropriate under the circumstances, provided that they are readily available to them under the laws of the host country.” See: Article 17, MIGA Convention.

<sup>13</sup> Para. 28, Commentary on the Convention.

providing political risk guarantees to cover investment in developing countries. This is in line with China's current policies.

Second, it demonstrates that Chinese authorities have full confidence in handling the domestic political situation, as well as China's capacity to provide foreign investors with political risk-free investment conditions. This will serve to ease the investors' concerns with regard to political risks. It is understandable that foreign investors worry much about their investment's security in a country which is in the transition from a planned economy to a market-oriented economy.

Third, it reflects China's practical diplomacy and willingness to safeguard the interests of developing countries in international organizations. According to the MIGA Convention, the voting power in the Agency reflects the view that developed and developing countries have an equal stake in foreign investment and therefore shall have equal voting power.<sup>14</sup> It is impossible for MIGA's Board to pass any important decision that is not in favor of developing countries, since all important decisions of the Board would have to be taken by a special majority of at least two-thirds of the total voting power, representing at least 55 percent of total subscriptions.<sup>15</sup> In fact, developing country's voting power has already reached 50% as originally designed.<sup>16</sup> From China's perspective, this is good progress, compared with the existing voting system of the Bank and IMF where votes are

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<sup>14</sup> Para. 63, Commentary on the Convention, 1985.

<sup>15</sup> Para. 63, Commentary on the Convention, 1985.

<sup>16</sup> Developing countries' voting power was 31%, 47.8% and 50.60 % respectively in 1991, 1994 and November, 1996.

distributed according to dollar subscriptions.<sup>17</sup> MIGA's voting structure challenged the dollar-voting system, and developing countries' interests could be safeguarded better through such a voting system. In addition, in line with the MIGA Convention, by joining MIGA, China could have one of the 22 seats in the MIGA Board,<sup>18</sup> with a representative of its own on the Board of Directors. China's voting power will be 3.6%, and it is thus the sixth biggest shareholder among MIGA members. This would no doubt provide China with another important forum in World Bank group, by which China could play a crucial role in safeguarding its own interests and those of other developing countries.

Fourth, it illustrated that China's legal system relating to foreign investment is linked with international practice by recognizing MIGA's Convention as an international commitment. MIGA played a catalytic role in accelerating China's recognition of an international investment insurance regime. This is not only because MIGA's Convention is a multilateral treaty which has been discussed for a long time between developed and developing countries, but also because MIGA's Convention is in conformity with China's bilateral investment protection agreements.

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<sup>17</sup> At the World Bank, the voting power distribution was: Part I countries (developed ) 62.99%, and Part II countries (developing) 32.41% as of November, 1996. At the IMF, the voting power distribution was: developed countries 61.2% and developing countries 38.8% as of November, 1996.

<sup>18</sup> By the end 1996 the seats on MIGA Board increased to 24.

### **III MIGA'S PORTFOLIO IN CHINA**

China signed the MIGA convention on April 28, 1988 and it fulfilled the other formalities a few days later, thus becoming a contracting party to MIGA. In November 1991, MIGA and China signed three agreements, which laid down a good foundation for MIGA's portfolio in China.<sup>19</sup>

However, the first contract for investment was not issued until 1993. MIGA's slow beginnings in China might have been due to the following: i) as a new agency, it took time to win name recognition; ii) there was an inhibiting effect on private capital flows to China after the political events of 1989;<sup>20</sup> iii) most investing enterprises are small or medium size, their investment were short-term-oriented and on a trial basis; and iv) some investors desired to avoid the "screening" system where MIGA's guarantee application are processed by both MIGA and China, and in China, by both local and central authorities.

As of January 1997, MIGA has concluded 18 contracts of guarantee in 11 projects in China, totaling over \$63.44 million. It has about 100 active registrations for prospective guarantees of projects in the country. These projects are in the sectors of agribusiness, construction, oil and gas, manufacture and infrastructure ( see details in Table 1 and Figure 1 - 4 ).

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<sup>19</sup> These three agreements are: i) Agreement on Legal Protection for Guaranteed Foreign Investments; ii) Agreement on Use of Local Currency ; iii) Guidelines on Approval of MIGA Guarantees, signed by MIGA and China Ministry of Finance in November 1991.

<sup>20</sup> Lorin S. Weisenfeld, "MIGA's Cooperation with China and its Potential Role", 1995.

**Table 1**

**MIGA's PORTFOLIO IN CHINA**

**(AS OF JANUARY 31, 1997)**

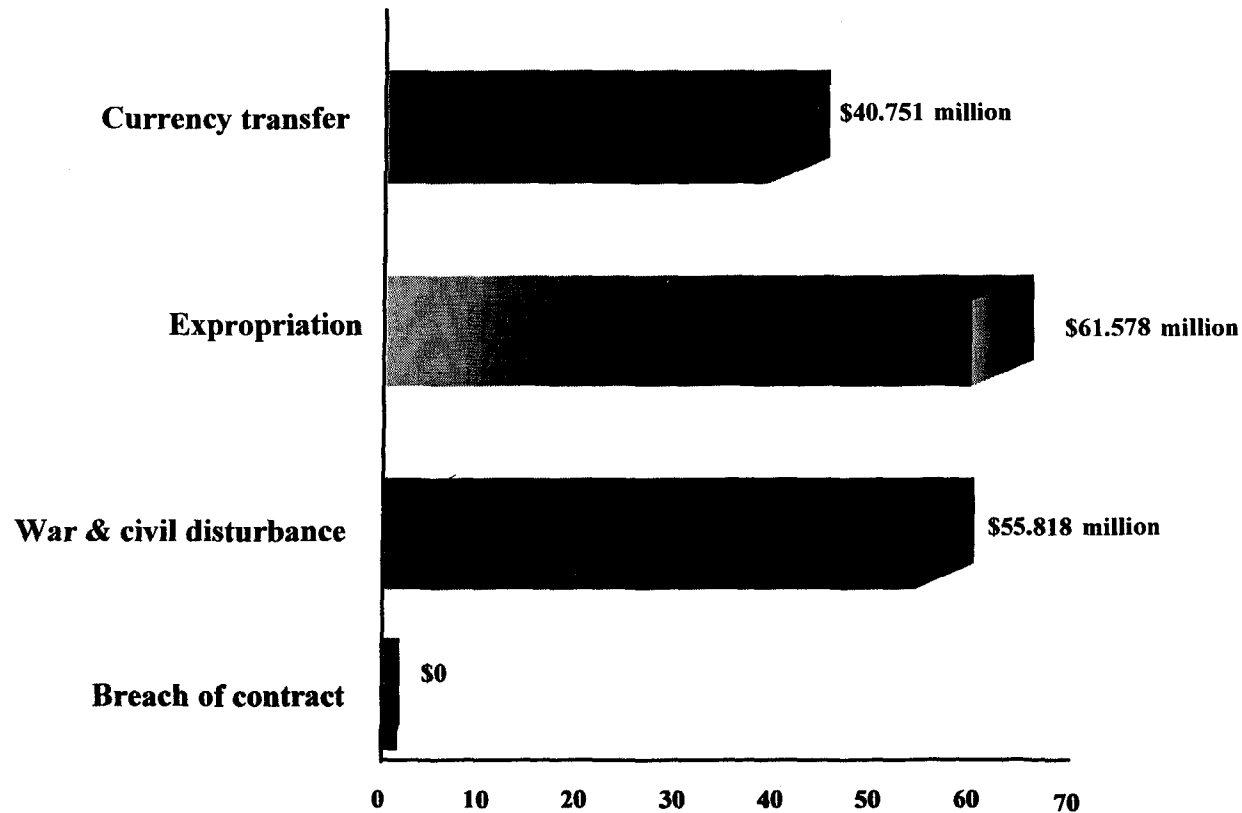
FY.	PROJECT NAME	DESCRIPTION	LOCATION	GUARANTEE COVERAGE MAX. LIABILITY PERIOD			GUARANTEE HOLDER	HOME COUNTRY
'92	SUZHOU LEDERLE PHARMACEUTICAL CO. LTD.	Construction and operation of a pharmaceutical plant	Suzhou, Jiangsu	(2)	\$ 7,000,000	15 yr.	American Home Products	United States
'92	CONTI AGRICULTURAL DEVELOPMENT CO. LTD.	Construction and operation of a JV producing chicken eggs	Wuhan Hubei	(2) (3)	\$ 766,000	15 yr.	Continental Enterprises Ltd.	United States
'92	WUHAN CONTI POULTRY BREEDING FARM LTD.	Construction and operation of 100% owned hatchery	Wuhan Hubei	(2) (3)	\$ 3,793,000	15 yr.	Continental Enterprises Ltd.	United States
'93	YIXING ST. LOUIS COPPER CO. LTD.	Est. & oper. of a JV copper-products manufacturing co.	Yixing City, Jiangsu	(2)	\$ 540,000	10 yr.	China Capital Devel. Corp.	United States
'93	SINOPEC- HONEYWELL (TIANJIN) LTD.	Sell, install, support, process mgt. + control systems	Tianjin City	(2) (3)	\$ 990,000	15 yr.	Honeywell Inc.	United States
'94	SHANGHAI SUNNEN PRODUCTS CO. LTD.	Assembly and marketing machine tools and related products	Pudong, Shanghai	(2) (3)	\$ 2,700,000	15 yr.	Sunnan Products Co.	United States
'94	SIKA SILK CORPORATION LTD.	Production of high quality silk	Chengdu, Sichuan	(1) (2) (3) (1) (2) (3) (1) (2) (3)	\$ 412,000 \$ 601,000 \$ 601,000	15 yr. 15 yr. 15 yr.	Pepsi-Cola International Ratti Technologies S.r.L. Shinwha Textile Co. Ltd.	United States Italy Korea
'94	SHENZHEN JIADIANBAO ELECTRIC PRODUCTS CO. LTD.	Acquisition and expansion of SJEP	Shenzhen	(2) (3)	\$ 6,900,000	15 yr.	Catalina Lighting Inc.	United States
'95	CPM SHENGCHANG LIYANG MACHINERY CO. LTD.	Joint venture to manufacture, marker animal food	Liyang City, Jiangsu	(1) (2) (3)	\$ 5,850,000	15 yr.	Ingersoll-Rand China Ltd.	United States
'95 to '96	HAINAN MEINAN POWER CO.	Construction and operation of Hainan Meinan power plant	Haikou, Hainan	(1) (2) (3) (1) (2) (3)	\$16,700,000 \$ 4,000,000	15 yr. 7 yr.	Atlantic Commercial Finance ING Bank	Netherlands Netherlands
'96	NANCHANG ANXIN OIL FACTS AND FEEDSTUFF (GROUP) CO. LTD.	Produce feed grains and oil by-products	Nanchang, Jiangxi	(1) (2) (3)	\$12,587,000	15 yr.	Andre & Cie S.A.	Switzerland

\* COVERAGE (1) = CURRENCY TRANSFER, (2) = EXPROPRIATION, (3) = WAR & CIVIL DISTURBANCE.

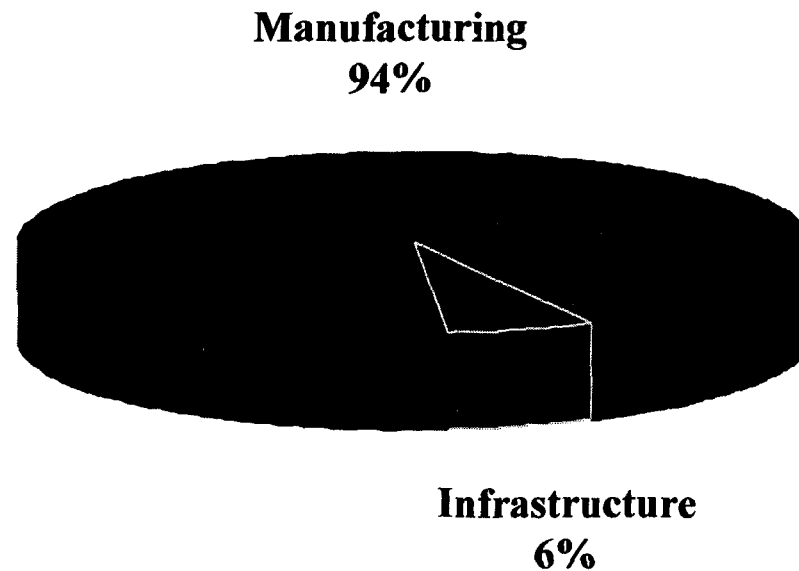
SOURCE: COMPILED FROM "MIGA ANNUAL REPORT", VARIOUS YEARS.



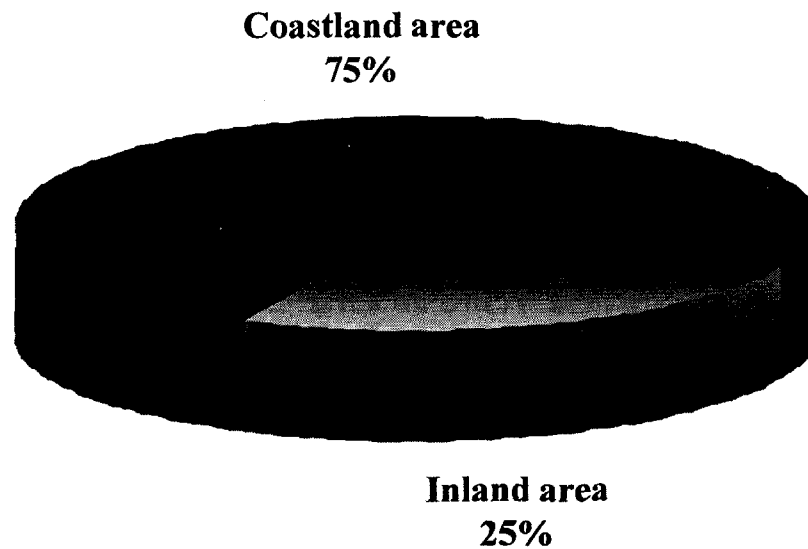
**Figure 1**  
**MIGA's China Portofolio by Type of Coverage**  
**(as of January 31, 1997)**



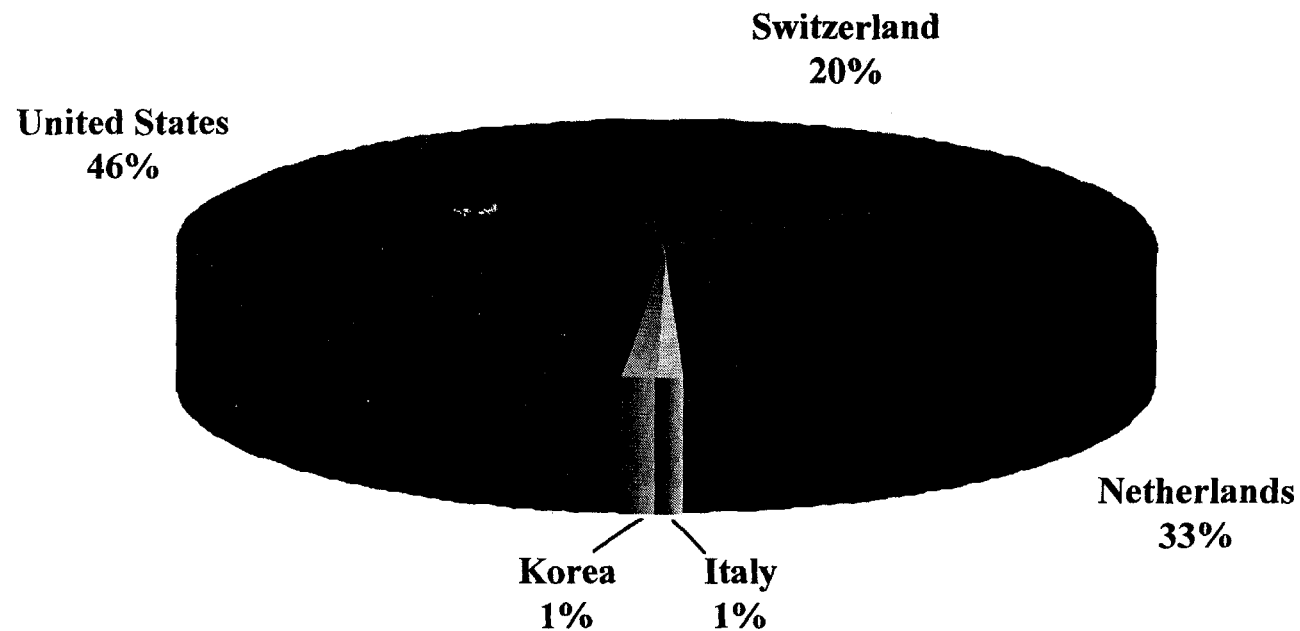
**Figure 2**  
**Distribution of MIGA' China Portfolio by Sector**  
**(as of January 31, 1997)**



**Figure 3**  
**Distribution of MIGA's China Portfolio by Geography**  
**(as of January 31, 1997)**



**Figure 4**  
**Distribution of MIGA's China Portfolio by Investor's Country**  
**(as of January 31, 1997)**



Is there any possibility of loss by MIGA in China ? How can potential claims be prevented ? The following section discusses MIGA's coverage.

### **1. Currency transfer risks**

Currency transfer risks, for a number of other reasons, normally occur because of a host country's international balance of payments difficulties. The host country could apply controls on foreign exchange, prohibiting or restricting foreign investors who seek to remit their legal profits or income out of the host country. According to international law, the right to impose foreign exchange controls is based on a country's sovereignty. So long as a host country's foreign exchange controls neither breach its obligations in related treaties or agreements nor injure other countries' monetary policy, no other nation may object. However, foreign investors could also suffer from the restrictions of foreign exchange controls introduced by a host country. That is why investors often put possible introduction of foreign currency transfer restrictions on the list of political risks.

MIGA may provide political risk coverage guarantee against restrictions on foreign exchange control, in terms of "an active restriction", which is, " a decision by the host government denying conversion and /or transfer of local currency or authorizing such conversion and transfer at an exchange rate less favorable than the lowest exchange rate determined under the contract of guarantee ..."; and in terms of "a passive restriction", which is, " a failure by the host country's exchange authority to act on conversion and/or

transfer within ninety days from the date on which the guarantee holder applies for conversion and/or transfer ...<sup>21</sup>

In China, foreign investors may transfer all or part of their foreign exchange outside China whenever they have reserves in their foreign exchange deposit accounts. It is hard to imagine that China would actively prohibit the remittance of currency abroad.

First, it is against the legislation in China to prohibit remittances. Foreign investors' lawfully earned income and profits are fully protected by law. For example, the Law of the People's Republic of China on Enterprises Using Foreign Investment clearly provides that: "Legitimate profits obtained from enterprises using foreign investment by foreign investors, other legitimate earnings and funds after clearing of accounts may be remitted abroad."

Second, recalling the 15 years reform, it is obvious that China's foreign exchange system achieved a great success: unification of foreign exchange rates were created instead of multiple currency practices. Separate exchange markets have been unified, and the scope of discriminatory policies have been substantially reduced. This demonstrates that China's foreign exchange system has relaxed restrictions gradually and is on track for greater liberation.<sup>22</sup>

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<sup>21</sup> Article 1.24, MIGA, Operational Regulation.

<sup>22</sup> For a detailed discussion of China's foreign exchange system reform, c.f. David Wall, Jing Boke and Yin Xiangshuo: "China's Opening Door", The Royal Institute of International Affairs, 1996.

Thirdly, foreign exchange reform, is a key component in the framework of China's economic reform, and it is tightly linked with other sectors such as import, export, and foreign investment. If some restrictions are introduced, other sectors would be affected, and some unintended consequences could follow.

Fourth, China's acceptance of Article VIII of IMF provided an additional safeguard for foreign investors. For instance, China will not increase restrictions on the transfer of profits. Because while accepting the obligations of Article VIII, China undertakes to refrain from imposing restrictions on the making of payments and transfers for current international transactions or from engaging in a discriminatory currency arrangement or multiple currency practices without IMF approval.<sup>23</sup>

However, there may be risks of "passive restrictions". Therefore, one point should be noted while examining MIGA's portfolio in China. Chinese regulations stipulate that Foreign Investment Enterprises (FIEs) must apply to the State Administration of Foreign Exchange Control (SAFE) or its branch offices for transfer by debiting the foreign exchange deposit account of the FIEs concerned. Thereafter, SAFE or its branches are supposed to respond in time to the FIEs' applications whether in favor or not, and any delay exceeding 90 days would be deemed as a currency transfer blockage, should any losses be incurred due to such delay.

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<sup>23</sup> China accepted the obligations of Article VIII of IMF Agreement on December 1, 1996. See: IMF News Brief, November 27, 1996.

## 2. Risk of expropriation and similar measures

Foreign investment has been provided full protection by legislation in China. “ Except under special circumstances, the State shall not nationalize or expropriate wholly-owned foreign enterprises. Should it prove necessary to do so in the public interest, legal procedures shall be followed and reasonable compensation will be made”.<sup>24</sup> Only in extraordinary circumstances, the State may carry out a compulsory purchase or requisition. For example, “ in case of war, threat of war or other state of emergency, the Chinese Government shall have the right of compulsory purchase or requisition with respect to a portion or all of the petroleum earned or purchased by the foreign contractor.”<sup>25</sup>

Compared with direct expropriation, foreign investors are much more concerned about the risk of indirect, or *de facto*, expropriation or similar measures. The MIGA Convention has an extensive definition of “the risk of expropriation and similar measures”, that is, “ any legislative action or administrative action or omission attributable to the host government which has the effect of depriving the holder of guarantee of his ownership or control of, or a substantial benefit from, his investment,...”<sup>26</sup> In addition, “host government” is defined by the Convention as including “any public authority” of the host

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<sup>24</sup> Article 5, the Law of the People’s Republic of China on Enterprises Operated Exclusively with Foreign Capital. 1979 .

<sup>25</sup> Article 26, Regulations of the People’s Republic of China on the Exploitation of Offshore Petroleum Resources in Co-operation with Foreign Enterprises, 1982.

<sup>26</sup> Article 11 a (ii), MIGA Convention.



country,<sup>27</sup> or, “for example, a *de facto* government over the territory in which the Investment Project is located.”<sup>28</sup> However, in order to balance the sovereignty of the host country and the need to protect foreign investment, the Convention has an exception clause, that is, it does not cover sovereignty acts that are “non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territories”.<sup>29</sup>

There are two points that should be noted while examining MIGA’s portfolio in China. First, it is necessary to provide information to the local government in which the MIGA-covered project will be located, in order to ensure appropriate knowledge on its part. This is important, since China is such a large country. Second, two trends should be avoided regarding the coverage of expropriation and similar measures, one is to attempt to construe the exception clause too widely, which would favor a host country; the other trend is to ignore the exception clause altogether in order to augment the guaranteed coverage, which would favor foreign investors.

### **3. War and civil disturbance risk**

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<sup>27</sup> Article 3, MIGA Convention.

<sup>28</sup> Article 1.35, MIGA Operational Regulations.

<sup>29</sup> Article 11 a (ii), MIGA Convention.

The definition of war and civil disturbance risk in the MIGA Convention is “any military action or civil disturbance in any territory of the host country”.<sup>30</sup> The possibility of outbreak of war or civil disturbance in China is quite limited due to: the ending of Cold War, the improved relations between the two sides of the Taiwan Strait and domestic stability. However, MIGA’s portfolio in China in terms of issuing guarantee against war and civil disturbance could have a twofold significance.

First, China has vast maritime petroleum and gas resources. This is one of the areas of China’s focus in seeking foreign capital. For example, China National Off-Shore Oil Corp. alone utilized US \$1.8 billion of foreign investments in the joint exploration of its maritime petroleum resources during 1990-93,<sup>31</sup> especially in the Spratly Islands area. Many Western petroleum companies are involved in this area. This area’s great resources attract not only Western petroleum companies, but also the neighboring countries. China’s position regarding neighboring countries’ claims on the sovereignty of the Spratly Islands area is that: it will be “laying aside disputations and carrying on joint exploration”. It is hard to forecast the possibility of outbreak of war in this sensitive area. Nevertheless, MIGA’s guarantee against war risk could ease investors’ worries.

Second, with regard to civil disturbance, MIGA could provide wide coverage against such risks which could take the form of riot or civil commotion. In China’s case, this

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<sup>30</sup> Article 11, a (iv), MIGA Convention.

<sup>31</sup> “1994 China Foreign Economic Statistical Yearbook”, China Statistics Publisher, 1995.

kind of events would hardly happen again. Because having experienced the 1989 Tiananmen Event, more and more Chinese realize that stability is a high priority for China. Civil disturbance is neither good for the people nor for the country. However, some investors could worry that similar events could happen in the future. MIGA's guarantee against such risk should dispel their worries about similar events.

#### **IV CHALLENGES AND RECOMMENDATIONS**

Since its inception, MIGA has played a significant role in helping developing countries to attract foreign direct investment, although the institution is only eight years old and has less than 100 people to serve 141 member countries.<sup>32</sup> In fiscal year 1996 (July 1995-June 1996), MIGA issued coverage of approximately US\$900 million, which has facilitated investment in the form of FDI of about US\$6.6 billion.<sup>33</sup> The ratio is about 1:7, that is to say, one dollar of MIGA-insured investment helps to mobilize over seven dollars. MIGA's catalytic role is well demonstrated. Also, MIGA plays a role to diffuse private FDI flow to developing countries, since only 30% of MIGA's coverage went to those 12 countries that receive 80% of FDI flowing to developing countries in 1995; the other 70% went to other developing countries.<sup>34</sup> How may MIGA assist developing countries to attract more FDI in light of the challenges discussed below ?

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<sup>32</sup> MIGA's size of budget and personnel employed are 1% of the World bank and 5% of the IFC. See details in: Akira Iida, Executive Vice President of MIGA, "*MIGA: the Standard-Setter of Investment Promotion Business*", Speech made at the Finans Dunyasi Dergisi, Istanbul, Turkey, February 19, 1997.

<sup>33</sup> Ibid.

<sup>34</sup> Ibid.

## CHALLENGES

### 1. Financial Constraints

MIGA was designed to be financially self-sustaining. As of January, 1997, its portfolio approached three times its initial capitalization ( 1 billion SDRs when the Agency was established in 1988). Because its portfolio has grown rapidly and performed well, MIGA could soon reach the limits imposed on it by its initial capitalization. MIGA is now starting to face a possible financial squeeze: by fiscal year 1998, its financial resources may be close to exhaustion (in terms of an allowable risk-to-asset ratio), unless its member nations agree on how to increase its capital.<sup>35</sup>

### 2. The Changing International Context

In recent years, private capital has surged into developing countries from banks, mutual funds, multinational corporations and other private sources. The net total private flow amount increased from \$44 billion in 1990 to \$167.1 billion in 1995.<sup>36</sup> Compared with the \$43.8 billion that the World Bank and other governments' official sources lent to developing countries in the same year, private capital took the lion's share of financial flows to the developing countries. The World Bank and other official sources no longer account

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<sup>35</sup> or some contracts are canceled.

<sup>36</sup> "World Debt Tables: External Finance for Developing Countries", World Bank, 1996.

for a bigger share as was the case. It looks almost paltry compared with the FDI amount that developing countries collectively attracted. In recognition of this reality, developing countries try their best to attract FDI. How may MIGA facilitate developing countries in attracting more FDI ?

### 3. The Changing Demand of Member Countries as the Case of China

In 1995 developing countries attracted \$90 billion in FDI, of which China alone received 45 percent, or \$ 38 billion.<sup>37</sup> China has a wide range of opportunities for investors, manufacturing (except investments related to national security, traditional crafts, and poisonous material ), energy, transportation, communication, and most of the service sector, while some developing countries still have various restrictions on these areas. It is hard for China to select high quality FDI at the beginning of attracting FDI.<sup>38</sup> However, as the increasing of inflow FDI and wider opening to the outside, China has more choice in selecting the upcoming FDI. Although China has a great demand for foreign capital, the attention of China on attracting FDI is now based on “quality” rather than on the “quantity” of investment, that is, to move FDI from a short-term, quantitative to a long-term qualitative strategy.

### 4. Relations with National and Private Issuers

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<sup>37</sup> “What determines foreign direct investment ?” DEC Notes, No. 16, World Bank, August 1996.

<sup>38</sup> For example, China only attracted US\$1.76 billion FDI in 1979-82.

MIGA's relations with other national and private issuers are both supplementary and competitive. MIGA's portfolio in a host country will be supplementary to and also be in competition with the portfolio of national and private issuers. Take MIGA's portfolio in China as an example. From Figure 4, we can see that the main investors come from the United States. However if OPIC resumes its political risk insurance business in China,<sup>39</sup> MIGA's portfolio might be affected negatively. In addition, one of the major source countries of FDI in China is Japan, but Japanese investors always go to their national issuer MITI for coverage against political risks instead of MIGA.

## RECOMMENDATIONS

To discuss MIGA's role in facilitating FDI to developing countries, two points should be borne in mind: first, MIGA is neither a commercial nor a national insurance institution. As an international institution, it should be responsive to its "client" --- member countries; and second, MIGA's comparative advantages are: i) its international experience in both underwriting and operating its portfolio; ii) its neutral position and approach which might be acceptable to both host countries and foreign investors; iii) its guarantee portfolio will not be affected by bilateral relations; and iv) its mediation and legal advice.

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<sup>39</sup> Post-Tiananmen Square determinations by the US Government have caused the suspension of OPIC program in China.

MIGA plays a role of “catalyst” to encourage FDI flow into developing countries.<sup>40</sup> In China’s case , MIGA may play a role of “screening” the investment in addition to its role as a “catalyst” for the following reasons:

1. The quality of FDI in China is not always high. It does not necessarily bring all the good things of FDI, such as technology and skills transfer. Enterprises with small and medium-size investments ( less than US \$1 million) occupied the major portion of FDI national total. Also, the level of technology is often low. Most joint enterprises include local town-village enterprises (TVEs) and overseas Chinese investors.

2. Investments in some sectors have already spilled over. Especially in consumer sectors, in which many foreign investors concentrated involved, for example, fast food, beverage, beer, detergents, cosmetics and shampoo. Detergents represented 32% of national output in 1995, beverage and beer took 39.7% and 20% of total national output in 1994.<sup>41</sup>

3. Local partners provided too many discounts to foreign investors. Some local officials are anxious to attract foreign investment and technology without considering the costs. For example, they underestimate the value of key assets such as land and machinery. Another example is the acceptance of unfavorable clauses in contracts, such as guaranteeing

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<sup>40</sup> MIGA could insure investments in either new projects or in the expansion, modernization, privatization, or financial restructuring of existing projects. MIGA could also cover different forms of investment: equity, shareholder loans, shareholder loan guaranties, technical assistance, and management contracts. See details in Geral T. West, “Investment Insurance”, *A LatinFinance*, June 1994 supplement.

<sup>41</sup> “China Investment”, April 1996.

investors' fixed returns of their investment without requiring them to take any commercial risk. That is, if the returns do not reach a certain annual percentage, the local partner of the investor should pay the difference through other financial resources.<sup>42</sup>

4. Many investment related to pollution-intensive industries. In 1991, foreign investors established 11,515 enterprises, and the contract investment amount to US \$ 8.77 billion. Among them respectively, 36.80% of total investment and 29.12% of enterprises were pollution-intensive industries.<sup>43</sup> The ratio is high mainly due to the fact that some foreign investors took advantage of local officials' anxiety to secure foreign capital to get temporary economic growth by sacrificing environment protection; and advantage of different standards regarding environment regulations, implementation between developed and developing countries.

In issuing a guarantee to an investment, MIGA's "screening" role is reflected in the following respects:<sup>44</sup> i) developmental and environment impact, that is, the economic soundness of the investment and its contribution to the development of the host country; ii) legal protection, that is, compliance of the investment with the host country's laws and

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<sup>42</sup> For example, there were articles regarding profits sharing in a contract. One stipulated that: "Part A shall ensure that the annual capital profit rate of Party B's investment, xx%, i.e. US\$ xxx,xxx and it shall be net payment. The contractual cooperative enterprise shall remit said payment to Party B's designated bank account by installment at the end of June and December of each year after the establishment of the contractual cooperative enterprise." In addition, another article stipulated that, on the expiration date of the above enterprise, "Part A shall guarantee to pay back to Part B investment principal of US\$ xxx,xxx plus all accrued profit." If Party A cannot fulfill this obligation, its guarantor should fulfill this obligation.

<sup>43</sup> Su Lin and Zhang Sunan, "Issues in China's Utilization of Foreign Direct Investment", p.142, 1996.

<sup>44</sup> This role is consistent with the MIGA Convention, the Operational regulations, and other policies adopted by the Board of MIGA. See: Article 12, MIGA Convention.



regulations; and iii) consistency of the investment with the declared development objectives and priorities of the host country. With such a screening, it is difficult for the above-mentioned investments to go through. Therefore, MIGA's screening role is more important than the role of catalyst in China's case.

Also, MIGA could play the role of "demonstration" by making full advantage of its limited capacity. The maximum amount of coverage that MIGA can issue for a single project is currently \$50 million and for a host country is \$225 million.<sup>45</sup> As Table 2 indicates, the amount of FDI flow into China is growing. Take 1995 as an example, China attracted US \$ 38 billion, while MIGA's exposure in China currently is about US \$ 80 million. Deducting the existing portfolio amounting to US \$63.44 million, only US \$ 96.36 million is left. Therefore, MIGA should leverage its remaining guarantee capacity to maximize the amount of "quality" foreign investment to China. As there is a Chinese saying: good steel should be used in the edge of a knife. For example, MIGA could play "demonstration" role in the following issues. These demonstration effects would manifest MIGA's commitment to promoting FDI into developing countries.

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<sup>45</sup> "Investment Guarantee Guide", MIGA, Sept. 1996 and MIGA Annual Report 1996.

Table 2 Contracted and Actual FDI in China: 1979 - 1995  
(\$ billion)

	79-82	83-87	88-90	1991	1992	1993	1994	1995
Contracted	6.01	16.858	17.493	12.422	58.736	111.43	82.68	90.288
Actual	1.76	1.442	1.184	4.666	11.291	26.023	34.45	37.736

Source: "China Statistics Yearbook", various year.

#### Streamlining the legal framework for FDI

Although China currently receives almost one third of all FDI among developing countries, the rules and regulations governing FDI still need to be improved. For example, some rules lack transparency, some lack uniformity and some are not completely in line with international practice.<sup>46</sup> Foreign investors pay attention to the rules and regulations governing FDI, which are mainly in areas of admission, treatment, currency transfer, expropriation of foreign investments and the settlement of disputes between governments and foreign investors. As China has a continued demand for FDI, it is necessary to design a rule-based legal system governing FDI in order to attract FDI on a continuing basis. China recently has embarked on a program to reform its legal system to complement and

<sup>46</sup> Although the issue of uniformity has been a two-edged sword for foreign investors, they tend to think that both transparency and uniformity are crucial for development of a rule-based system of commercial law. See, Person, Margaret. "China's Integration into the International Trade and Investment Regime, November 1996".

implement the market economy which is the goal of its economic reform. Laws and regulations will be enacted and revised in a wide range of fields. MIGA could facilitate the establishment of a sound legal framework to encourage greater FDI in China by increasing foreign investor's confidence in their reliance on laws and regulations which apply to their investments.

#### Policy advice papers

In the course of attracting foreign investment, some unintended consequences occur and some problems need to be solved. Different suggestions were offered to the authorities. Due to its neutral position, MIGA's policy recommendations are more likely to be considered or accepted by the authorities.

MIGA, for example, could provide a policy paper on the issue of "national treatment". That is because Chinese authorities meet domestic complaints about the alleged "unfair" competition from foreign companies. But questions about: how to shape uniform national treatment, of both foreign investors and domestic companies in order to provide equal competition, which could protect the interests of domestic companies while not harming foreign investors ? In other words, how could China still attract FDI while not harming domestic companies ? MIGA could analyze what kinds of national treatment, according to international practice, could be granted to foreign investors.

Also, MIGA could provide a policy paper analyzing the environment for investment in infrastructure in China. Some foreign investors do want to invest in this area with large sums of money, but request extensive concessions, considering the risks they will face in the long run.<sup>47</sup> MIGA could make detailed suggestions with comparative analysis and assessment regarding the justification of these “concessions” compared with other countries’ experiences including other transition economy countries. Feedback from private investors to Chinese authorities would be useful in this respect. This kind of policy papers would definitely provide good reference to the policy makers in the central and local government.

#### Priority sector

Figure 2 indicates that the major portion (94%) of MIGA’s distribution of portfolio by sector in China has gone into manufacturing. Comparatively, from Table 3 we can see that the major portion of FDI has also gone into the industrial and real estate sector, accounting for nearly 83.1% of the national total. However, less FDI went into other needy sectors of economy such as agriculture, transport and communications (about 3.3 % of national total).

It should be noted that these sectors are not only the backbone of any economy, but also play a key role in attracting more foreign investment. In addition, in terms of industrial

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<sup>47</sup> For example, they want the central government to stand behind loans made to enterprises carried out at the national level, provincial governments, and state owned enterprises to be guaranteed by the central government. see: Larry L. Simms “The stake of the inland region in the development of China’s legal system” paper delivered at the Fourth Annual US-China Inland Economic Development Seminar, Chengdu, China, Oct.13-16,1996.

sector, more foreign investment has gone into labor intensive projects such as garments, textiles, and electronics. China could not benefit from the advanced technology and equipment which is supposed to come along with inflow FDI. The Chinese authorities have realized that they should divert the attention of foreign investors by guidelines of industrial policy, and also should encourage investment in high-tech industries, rather than labor-intensive ones. On March 25, 1994, The China State Council issued a document entitled: "The Framework of National Industrial Policy for 1990s", which pointed out three kinds of industries as priority industries: infrastructure and basic industries; leading (pillar) industries; and new & high-technology industry.<sup>48</sup> This could also be a good reference for MIGA while issuing guarantees in China.

Table 3 Foreign Direct Investment in China (contracted) by Sector (1979-1995)

Sector	Percentage of national total (%)
Agriculture	1.5
Communication and Transportation	1.8
Construction	2.6
Commerce, Ford Service, Material Supply and Marketing	3.8
Real Estate, Public Utilities	28.1
Industry (garments, textiles, electronics, and plastics, etc.)	55.0
Other	7.2

Source: computed from China State Planning Commission (SPC).

<sup>48</sup> China State Planning Commission, 1994.

### Priority regions

The major portion of MIGA's portfolio by geography in China is concentrated in the coastal area amounting for about 75%, while investment in the inland area (central and western China) amounted for only to 25% (see Figure 3) . As we know, the economic gap between coastal area and inland area is growing. This wide gap could be harmful to the economic development in the country. It also could lead to polarization of the developed coast versus the developing inland area. This generates a negative impact not only on China's economy as a whole, but also on the social stability of the country. The inland area is the priority of the national development plan. China's current Ninth Five-Year Plan (1996-2000) emphasizes the need to foster the development of the comparatively backward interior provinces and to attract foreign investment to such areas. Also, infrastructure investment and financial assistance to the area was committed by the central government.

As early as June of 1993, MIGA and Ministry of Finance of China sponsored a seminar "Foreign Direct Investment Promotion to the Western Provinces of China" in Chongqing City located in western China. This seminar could be considered as a signal of MIGA's efforts to encourage investments into inland area. Two projects in the inland areas have been issued guarantee by MIGA since then. This shift was appreciated and should be encouraged to grow.

## Reform of SOEs

State-owned Enterprises (SOEs) still occupy a central role in national economy. The slow pace of structural reform in this sector has curtailed economic development. One of the priority tasks for the Chinese government is to increase the market orientation of SOEs by deepening structural reforms, to enable SOEs to adapt to market forces. Foreign investments with advanced technology, skill and capital input, are encouraged to invest in SOEs by the government. MIGA could support transformation of SOEs by providing insurance to investors involving in SOEs against political risks. To be qualified under MIGA's criteria of "new investment",<sup>49</sup> the foreign investment should be used to modernize, expand, or enhance the financial viability of existing SOEs. In addition, the selected SOEs should operate on a commercial basis although they are owned by the State, in order to be qualified as eligible investment. MIGA's involvement will relieve investor's worries and take the lead to encourage more FDI into SOEs.

## Promote South-South Investment

According to official registration, China's investment overseas reached \$5.5 billion by July of 1996.<sup>50</sup> In addition to Hong Kong and Macao, investments by Chinese nationals have been made in countries around the world, such as US, Canada, Australia, Japan, Thailand, Singapore, Chile and Eastern European countries. A large portion of China's overseas investment was in developed countries. But in recent years, investment

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<sup>49</sup> Articles 1.12, MIGA Operational Regulations.

<sup>50</sup> "China Financial News", July 24, 1996. This includes the investment in Hong Kong and Macao, which is considered as overseas investment in China's statistics.

into developing countries has increased. Almost all these investors are state-owned enterprises but operating on a commercial basis, and therefore qualified as eligible investors.<sup>51</sup> However, there is no national or private agency in China that could provide insurance against political risks. The People's Insurance (Property) Company of China Ltd. does have a "political insurance policy", but it is mainly for foreign investors in China. Therefore, MIGA could be the best choice for China's investment in other developing countries, especially the investment in countries that do not have bilateral investment protection agreements with China. Two facts could be impediments to this possibility: one is that China's investors might lack knowledge about MIGA. In this regard, MIGA's promotion activity should be strengthened. The other fact is that China's major investment outflow is into developed countries, in which MIGA cannot operate, however this might change into developing countries as China's economy develops.

#### Training negotiators regarding BITs with major FDI source countries

China has signed about 71 Bilateral Investment Treaties (BITs) with other countries.<sup>52</sup> Recent developments of WTO and OECD might have some effect on the content and standards of current BITs. WTO is seeking the establishment of a multilateral investment regime, and the report was discussed in the ministerial meeting held in Singapore in December, 1996.<sup>53</sup> In the meanwhile OECD is working on the Multilateral Agreement on

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<sup>51</sup> "Where the majority of the equity in the investor is publicly owned, the Underwriting Authority must determine whether the Applicant operates on a commercial basis", Article 1.19, MIGA Operational Regulations, 1993.

<sup>52</sup> According to the statistics of ICSID (International Center for Settlement of Investment Disputes), as of November, 1996, 71 countries have signed BITs with China.

<sup>53</sup> See details, *Financial Times*, p.4, and p.13, October 17, 1996.



Investment (MAI), which would provide a broad multilateral framework for international investment regimes and investment protection with effective dispute settlement procedures. MIGA could provide its expertise to train Chinese BITs negotiators on the following elements incorporated in BIT, such as: i) most-favored-nation treatment for foreign investors for entry and operational conditions; ii) prohibition of TRIMs, such as export performance requirements, local content; iii) binding international arbitration for investor and State disputes; and iv) international law standards for expropriation.

#### *V CONCLUSION*

This study illustrates that China's evolving relationship with MIGA is a good one, which lays a solid foundation for further development. The process of China's participation in MIGA argues for good interactions between an international institution (MIGA) and one of its member states (China). On one hand, China's participation illustrates China's recognition and support of MIGA. At the initiating phase of establishing MIGA, while the controversy between developed and developing countries still existed, as a large developing country, China's participation no doubt enhanced support for MIGA. On the other hand, MIGA provided support in influencing the internal mechanism of China's reform, and further played a supporting role for shaping policies in domestic discussions on foreign investment at a time when views were controversial in this regard.

China's case demonstrates that MIGA played an active role in integrating a developing country into the multilateral investment system. Its role could be classified in a threefold: through project portfolio, policy advice and high level contact between MIGA management and the Chinese government. This kind of role cannot be matched by any national or private insurance institution. In addition, with regard to a long term political risk investment insurance, no national or private insurance institutions could compete with MIGA. Therefore, MIGA's unique function and comparative advantage in facilitating FDI into developing countries should be further developed.

Private sector investors pay more attention to the countries where they intend to invest. They look for good practice in economic reform and try to avoid places which have impediments to foreign investment. In this regard, MIGA, with its advantages as an international institution, with more than one hundred developing member countries, could help to facilitate private capital flows to developing countries. To take full advantage of MIGA, in order to maximize the developmental effects with limited financial resources, MIGA's role of screening and demonstration should be strengthened in addition to the role of catalyst. For those member countries that already have attracted FDI, the role of "screening" and "demonstration" should be strengthened; and for those member countries that are not able to attract FDI, the role of "catalyst" should be strengthened.

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